CHAPTER 2

Overview of the Resolution Process

Introduction

This chapter provides an overview of the specific steps undertaken by the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) to complete a resolution of a failing or failed institution. The intent is to provide background for the reader. Chapters 3 through 7 then trace in more detail the evolution of issues associated with, and results of, various resolution alternatives employed by the FDIC and the RTC between 1980 and 1994.

Resolution Methods

The three basic resolution methods for failed and failing institutions are a deposit payoff, a purchase and assumption (P&A) agreement, and an open bank assistance (OBA) agreement. Through the years, the FDIC and RTC have used these transactions in a number of variations, which are discussed in later chapters.

In a deposit payoff, as soon as the bank or thrift is closed, the FDIC is appointed receiver, and all depositors with insured funds are paid the full amount of their insured deposits.[1] Depositors with uninsured funds and other general creditors of the failed

1. The FDIC's insurance limit is $100,000. Any amount over that limit, including interest, is uninsured. The FDIC uses the term "insured depositor" to refer to any depositor whose total deposits are under the insurance limit. Similarly, the term "uninsured depositor" is used to refer to those depositors whose total deposits are over the insurance limit. It is important to note that customers with uninsured deposits are paid up to the insurance limit; and only that portion of their deposits over $100,000 is uninsured. Deposit payoff is described in more detail in Chapter 3, Evolution of the FDIC's Resolution Practices.

institution are given receivership certificates entitling them to a share of the net proceeds from the sale and liquidation of the failed institution's assets.

The P&A agreement is a closed bank transaction in which a healthy institution (generally referred to as either the acquirer or the "assuming" bank or thrift) purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. The acquirer usually pays a premium for the assumed deposits, decreasing the FDIC's total resolution cost. For most of the FDIC's history, P&A transactions have been the preferred resolution method.[2]

In an open bank assistance agreement, the FDIC provides financial assistance to an operating insured bank or thrift determined to be in danger of closing. The FDIC can make loans to, purchase the assets of, or place deposits in the troubled bank. Where possible, assisted institutions are expected to repay the assistance loans. While used in a number of situations during the 1980s, including for the resolution of several larger failing banks, that method has not been used since 1992.[3]

Resolution Process

Between the time it receives notification that a bank or thrift institution is about to fail and the time it develops the actual plan for closing the institution, the FDIC performs a number of specific tasks. Those tasks include processing the failing bank letter, developing an information package, performing an asset valuation, determining the appropriate resolution structure, and conducting an on-site analysis to prepare for the closing.

Failing Bank Letter

When an insured bank or thrift is about to fail, the FDIC initiates its resolution process. An institution is typically closed by its chartering authority when it becomes insolvent, is critically undercapitalized, is implicated in a discovery of a severe case of fraud, or is unable to meet deposit outflows.[4] The chartering authority, which is the state banking agency for state chartered institutions, the Office of the Comptroller of the Currency for national banks, or the Office of Thrift Supervision for federal savings institutions, informs the FDIC when an insured institution will be closed.

2. For further information, see Chapter 3, Evolution of the FDIC's Resolution Practices.

3. For further information, see Chapter 5, Open Bank Assistance.

4. In 1991, the FDIC was given the authority to close an institution that was considered to be critically undercapitalized (having a ratio of tangible equity to total assets equal to or less than 2 percent) and that did not have an adequate plan to restore capital to the required levels. The FDIC was also given the authority to close an institution that had a substantial dissipation of assets due to a violation of law, operated in an unsafe or unsound manner, engaged in a willful violation of a cease and desist order, concealed records, or ceased to be insured.

The FDIC's formal resolution activities begin when a financial institution's chartering authority sends a "failing bank letter" advising the FDIC of the institution's imminent failure. After the FDIC receives a failing bank letter, a planning team contacts the chief executive officer of the failing bank or thrift to discuss logistics, to address senior management's involvement in the resolution activities, and to obtain loan and deposit data from the institution or its data processing servicer. After the FDIC receives the requested data, a team, usually consisting of 5 to 15 specialists, is sent to the bank or thrift to gather and analyze additional information. The team prepares an information package to give to potential bidders, assigns a value to all the assets of the institution, estimates the amount of uninsured deposits, determines the resolution structures to be offered, and plans for the closing and receivership.

The Information Package

As part of its analysis, the FDIC develops detailed data for the information package on the amounts and types of assets and liabilities that the institution holds. The information varies depending on each institution's business strategies as reflected in its asset and liability structure. For example, if a failing bank is involved primarily in residential mortgage lending, the FDIC will develop information on the basis of that bank's asset characteristics such as interest rates and loan terms, as well as the performance of the portfolio (performing versus nonperforming).

Asset Valuation

Simultaneously, the FDIC begins a review of the failing institution's assets using asset valuation models to estimate the liquidation value of the assets, which is used in calculating the cost of a deposit payoff. Because the FDIC does not have enough time to assess every asset, it uses an extensive statistical sampling procedure. Loans are divided into categories, such as real estate, commercial, and installment, and within each category the loans are identified as performing or nonperforming. For each subcategory of loans, a sample is identified and reviewed carefully to determine an estimated liquidation value. Adjustments are made to discount future cash flows and to account for liquidation expenses. The loss factor that results from that estimate is then applied to the subcategory of loans that were not reviewed.

The Resolution Structure

The FDIC uses all the previously discussed information to determine the appropriate resolution structures to offer potential bidders. In compiling the marketing strategy, the FDIC considers the asset and liability composition of the failing institution, the competitive and economic conditions of the institution's market area, any prior resolution experience with similar institutions in the same geographic area, and any other relevant information such as potential fraud at the institution. Using that information, the FDIC determines how best to structure the sale of the bank or thrift.

The primary decisions include the following factors:

- How to market the failed institution; that is, whether to sell it whole or in parts. Portions of the bank or thrift, such as its trust business, its credit card division, or its branches, may sell best as separate transactions.
- Which types or categories of assets should be offered to purchasers.
- How to package saleable assets; for example, should the acquirer be required to purchase them, should they be offered as optional asset pools, or should they be sold with loss sharing?[5]
- At what price the assets should be sold; for example, book value, a fixed value estimated by the FDIC, or reserve pricing.

Preparation for the Closing

Finally, the FDIC conducts an on-site analysis to prepare and plan for the closing. The FDIC estimates the number and dollar amount of uninsured deposits at the institution, determines and analyzes the extent of any contingent liabilities, and investigates whether any potential fraud is present.

Marketing a Failing Institution

After gathering the necessary information and determining the appropriate resolution structure to be offered, the FDIC begins to market confidentially the failing bank or thrift as widely as possible to encourage competition among bidders. The FDIC's bank examination force compiles a list of potential acquirers consisting of financial institutions and private investors. In compiling the list, the FDIC takes into account geographic location, competitive environment, minority owned status, overall financial condition, asset size, capital level, and regulatory ratings. Before they can bid, private investors not only need to have adequate funds, but they need to be engaged in the process of obtaining a charter. They cannot purchase a failed institution unless they have obtained the necessary approvals from the chartering authority.

5. Optional asset pools and loss sharing, methods for selling assets, are discussed further in Chapter 3, Evolution of the FDIC's Resolution Practices, and Chapter 7, Loss Sharing.

The Information Meeting

The FDIC invites all approved bidders to an information meeting. After signing confidentiality agreements, the bidders receive copies of the information package, including the financial data on the institution, legal documents, and other documents describing the various resolution methods being offered. At the meeting, the FDIC discusses the details of the failing institution, the resolution methods offered, the legal documents, the due diligence process (bidders' loan review), and the bidding procedures. Chartering authority officials describe the regulatory requirements for bidding, as well as the application process for branches or new charters. Typically, the transaction terms are focused on the treatment of the deposits and assets held by the failing bank or thrift. The FDIC also advises the bidders about the types and amounts of assets that pass to an acquirer as part of each of the various transaction terms; which assets the FDIC plans to retain; terms of the asset sale, such as loss sharing arrangements and optional asset pools; and other significant conditions that are part of each proposed resolution method.

Bidder Due Diligence

Approved bidders who have signed confidentiality agreements are invited to conduct due diligence at the failing institution. Due diligence is the bidder's on-site inspection of the books and records of the institution and the bidder's assessment of the value of the assets and liabilities. The failing institution's board of directors must pass a board resolution authorizing the FDIC to conduct due diligence before bidders visit the institution. All bidders performing due diligence are provided the same information, so no bidder has an advantage.

Bid Submission

After all bidders have completed due diligence, bidders submit their proposals to the FDIC. Ideally, they will submit proposals 12 to 15 days before the closing, but they often submit them as close as 6 or 7 days before closing. All bids, including those that do not conform to the FDIC's previously identified resolution methods (referred to as nonconforming bids), are evaluated and compared with one another and with the FDIC's estimated cost of liquidation to determine the least cost resolution.

A bid has two parts: One amount, called the premium, is for the franchise value of the failed institution's deposits; the second amount is what the bidder is willing to pay for the institution's assets to be acquired. The first figure generally represents the bidder's perception of the value of the customer base; the second amount reflects the bidder's perception of the imbedded losses and the level of risk associated with the assets.[6]

6. The latter figure results in a net payment from the FDIC to the acquirer. For example, if the acquirer assumes responsibility for $100 in deposits and views the assets with a book value of $100 as being worth $80, then the acquirer will expect a $20 payment from the FDIC to make up the difference.

Least Cost Analysis

In selecting the resolution method, the FDIC has changed procedures over the years. Before 1991, the FDIC could effect any resolution transaction that was less costly than a deposit payoff. While the estimated cost of the resolution method has always been important, the FDIC at times considered other factors before making its final selection. Deposit payoffs were at times discouraged because of the effect that type of resolution method had; it reduced the availability of local banking services in smaller communities. The FDIC also looked at broad issues such as the effect certain resolution methods may have on banking stability and on discouraging shareholders and creditors of insured institutions from excessive risk-taking actions. At times, the FDIC also considered the effect the selected method had on increasing the inventory level of loans being serviced by the FDIC. In 1991, because of a change in the law, the FDIC amended its failure resolution procedures to accept the "least cost" bid.[7]

The least cost procedures require the FDIC to choose the resolution method in which the total amount of the FDIC's expenditures and liabilities incurred (including any immediate or long-term obligation and any direct or contingent liability) has the lowest cost to the deposit insurance fund, regardless of other factors.[8]

The FDIC determines the least costly resolution transaction by evaluating all possible resolution alternatives and computing costs on a present value basis, using a realistic discount rate. The overall cost to the FDIC of a failed institution depends on a number of factors, including the following:

- The difference between book values of assets and liabilities of the bank;
- The levels of uninsured and insured liabilities;
- The premium paid by the acquirer;
- Losses on contingent claims;
- The realized value of assets placed in liquidation by the FDIC; and
- Cross guarantee provisions against affiliated institutions.[9]

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7. Least cost is terminology used by the FDIC to refer to the bid alternative for a failing institution in which the total amount of the FDIC's expenditures and obligations incurred is the least costly to the deposit insurance fund of all possible resolutions for that failed institution.

8. The only exception is if there is a finding of "systemic" problems affecting the financial marketplace. Such a finding requires a two-thirds vote of the FDIC's and the Federal Reserve's boards of directors and concurrence by the secretary of the Treasury after consultation with the president of the United States.

9. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 included a cross guarantee provision that allows the FDIC to recover part of its resolution cost by seeking reimbursement from affiliated institutions. That provision was designed to prevent affiliated banks or thrifts from shifting assets and liabilities among themselves in anticipation of the failure of one or more of the institutions.

In most cases, the FDIC will receive at least one bid that is less costly than the estimated cost of liquidation.[10] If the bid includes assumption of all deposits, including uninsured deposits, the premium paid must be at least as large as the losses that would have been incurred by customers with uninsured deposits in a payoff in order for the bid to be considered less costly.

FDIC Board Approval

The FDIC staff submits a written recommendation to the FDIC Board of Directors requesting approval of the resolution transaction. The recommendation includes a copy of the least cost analysis and information about the share of the estimated loss that should be absorbed by customers with uninsured deposits. It also addresses whether an advance dividend should be paid to customers with uninsured deposits so they can receive a portion of their claim while the FDIC proceeds with the resolution and disposition of the remaining assets.

The FDIC Board of Directors is ultimately responsible for determining the least costly transaction. The board may direct that the winning bid determination be delegated to the appropriate division director. After the board approves the transaction, the FDIC staff notifies the acquirer, all unsuccessful bidders, and the chartering agency. The FDIC then arranges for the successful acquirer to execute the appropriate legal documents before the closure. At that time, the FDIC staff meets with the acquirer to coordinate the mechanics of the closing procedures.

Closing the Institution

The final step in the resolution process occurs when the institution is closed, and the assets that the acquirer purchased and the deposits that it assumed are transferred to the acquirer. The chartering authority closes the institution and appoints the FDIC as receiver. The FDIC, as receiver, is then responsible for settling the affairs of the bank or thrift, which includes balancing the accounts of the institution immediately after closing; transferring certain assets and liabilities; and determining the exact amount of payment due the acquirer (the liabilities assumed, less the assets acquired and the premium). The settling of various accounts between the receiver and the acquirer is called “settlement.”

10. From 1980 through 1994, out of 1,617 failing or failed bank situations handled by the FDIC, 1,188 banks, or 74 percent, resulted in purchase and assumption agreements. Deposit payoffs or insured deposit transfers (IDTs) were used in 296 cases, or 18 percent of the total. Open bank assistance accounted for 133 transactions, or 8 percent of the total.

Usually by the next business day, the acquirer will reopen the bank or thrift premises, and the customers of the failed institution with insured funds automatically become customers of the acquiring bank and can gain access to their money. As receiver, the FDIC is responsible for operating the receivership, including collecting any of the failed bank's assets retained by the receiver and satisfying the claims against the receivership of the failed institution. In cases where the FDIC provides continuing assistance, such as in a loss sharing transaction, the FDIC will monitor the assistance payments during the duration of the agreement, typically over several years.

Resolution Time Line

The entire resolution process is generally carried out in 90 to 100 days, not including the settlement timeframes. It begins when the chartering authority advises the FDIC that an insured institution is in imminent danger of failing and ends when the chartering authority appoints the FDIC as receiver. Sometimes the usual resolution process cannot be fully completed before the institution fails, however, such as in cases of sudden or severe liquidity problems. In those instances, the FDIC usually does not have time to prepare a review of the assets on site,[11] leaving a greater likelihood the FDIC will retain the failed institution's assets while structuring a more immediate solution for the institution's deposits and other liabilities. Three primary alternatives available in the face of such time pressure are a transfer of only the insured deposits,[12] a deposit payoff, or the formation of a bridge bank. A bridge bank is a newly created national bank designed to maintain the operations of an institution until a more permanent solution can be completed.[13]

11. When there is insufficient time to perform an on-site review, the FDIC uses its research model to value all or most of the assets. The research model is based on the FDIC's historical recovery experience for six broad categories of assets belonging to a sample of prior bank failures.

12. A transfer of insured deposits (insured deposit transfer) is a variation of a deposit payoff in which another financial institution takes responsibility for paying insured depositors the amounts they are owed. See Chapter 3, Evolution of the FDIC's Resolution Practices.

13. For further information, see Chapter 6, Bridge Banks.

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The FDIC's resolutions methods evolved from passing few failed bank assets with little risk to an acquiring institution to passing most failed bank assets and sharing the risk with the acquiring institutions.